THE IMPACT OF FINANCIAL SECTOR REFORMS ON THE BUDGET AND THE BALANCE OF PAYMENTS

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This paper is one of the 18 papers, published under a special series of publications by the Sri Lanka Economic Association (SLEA) with financial assistance from the United States Agency for International Development (USAID). The objective of these publications is to provide economic literature on current and topical themes on the economy of Sri Lanka to a broad audience that is interested in economic issues, but has little or no background in theoretical economics, while maintaining high analytical standards. Hence, the papers have been written in simple language avoiding the use of sophisticated technical terms, mathematical equations and models etc. which are normally found in economic literature.

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The Effects of the Earlier Restrictive Policies

Since the process of the liberalisation began in late 1977 a wide range of reforms have taken place in the financial sector. In the two decades preceding 1977, the increasing restrictions that were applied on various sectors of the economy and the absence of efforts to increase the efficiency of the economic activities and institutions had widespread and far-reaching adverse repercussions on the economy. In fact, the two key variables the budget and the balance of payments, which to a large extent reflect the general health of the economy, were under tremendous pressure at this time. This was so in a background where there was little investment, development and growth. The era of restrictive policies however coincided with the progressively increasing welfare commitments of the administration. The welfare expenditures were met entirely by funds provided from the budget and there was little or no foreign assistance available for these welfare programmes.

The welfare expenditure, no doubt, had very favourable and far reaching results on the population. Unlike in many other developing countries, where such programmes were not found, in Sri Lanka the welfare programmes had a major impact in vastly improving the physical quality of life of the people. At the same time, it tended to reduce the level of poverty and keep large numbers from falling far below a minimum level of subsistence. Between 1956 and 1977, the major issue was a trade off between a higher physical quality of life and economic growth. The socialist administrations of this period concentrated all effort on improving social welfare rather than promoting economic growth or striking a balance between the two. The advantage was that widespread welfare commitments had a direct impact on the physical quality of life and these benefits were more or less uniformly made available to all segments of society.

The alternative strategy of higher per capita income, increase in production and capital resources through high economic growth would have only benefited the people indirectly. Its effects would not have been uniformly felt since private sector based high economic growth, without specific mechanisms for income distribution, would have taken a long time to seep down to the common people in the form of higher incomes and better living standards, and in any event, the benefits would not have spread uniformly. Furthermore, under a private sector led development programme, the beneficial effects of higher growth rates of production and incomes would have been inequitably distributed because these benefits would largely accrue to those who are engaged in economic activity, while those that have the misfortune not to do so would be left out. Within this framework, the pre 1977 socially oriented welfare policies were targetted on everyone, that is, those who were well-off and those who were far less fortunate.

As far as the budget was concerned the socially oriented welfare programmes imposed severe strains because the government had to continuously find additional funds to finance the expanding welfare services which resulted in progressively increasing deficits in the budget from around 1956. Budget deficits could have been avoided only if there was strong economic growth and equally effective economic management which could have provided the budget with additional sources of funds from taxation. However, a relatively static and dormant economy gave few new avenues of revenue. The economy gave limited opportunities for mobilising more funds as there was little or no expansion in the ongoing activities in these two decades. The government had hardly any resources to embark on large scale new development work. At that time, the private sector had no place, because the government had taken over all economic functions and its plan was to further expand the government sector at the expense of private business and economic activity.

The impact of the policies of this period on the balance of payments was equally adverse. The objective was to ensure that Sri Lanka's import capacity would be roughly equal to the value of its exports, while through restrictions, controls and strict management of foreign exchange, import and other outward payments were minimised. Although, the balance of payments was in deficit, even with these severe restrictions the country did not face really serious problems in regard to the balance of payments. Because within this policy framework, when ever the government found it difficult to meet its commitments, all it had to do was to further cut down imports and overseas payments. Under the ongoing restrictive policies, the government always had the option available to further reduce imports in time of crisis. As long as the government had foreign exchange to pay for basic essentials, particularly, food, clothing and fuel, it could carry on without much difficulty.

It must be remembered that due to the policy of consumer subsidies which prevailed throughout that period, essential items, particularly food, clothing and fuel were made available to the people at artificially low prices. As far as essentials were concerned, consumption levels were maintained at artificially higher levels than it would have been the case, if prices were freely determined in the market. But the major impact of this policy was on the import levels at that time, where due to artificially low prices, imports of essential goods were probably much higher than it would have been, had the demand for goods and services been determined by market prices. For instance, since rice, flour and sugar were available at prices which were sometimes lower than in the producing countries or the cost of production, consumption was artificially maintained at a high level and this had a serious effect on both the budget and the balance of payments.

The effect on the balance of payments was that where subsidised items were concerned, imports ran at much higher levels, than it would have been in the absence of subsidies thus sharply increasing the gap between imports and exports. The very reason that there were subsidies meant that all the money to subsidise the essential goods and services had to come from the government budget. Transfer payments for welfare were a heavy item in the budget. Looking at it in another way, while imports of subsidised items were running at a high level the resulting import expenditures had to be met out of scarce foreign exchange. Social welfare transfer expenditure kept budgetary expenditure at a very high level and the government found it extremely difficult to find the additional funds. The increasing subsidies and welfare commitments had to be met out of funds that had to be collected from a relatively few sources of revenue which had been taxed to the maximum possible extent. Where money could not be found from taxation, additional funding for this purpose was obtained by increasing domestic borrowings. Most of the latter came from financial institutions like the National Savings Bank and the Employees Provident Fund having captive funds. Since there were even limitations on the levels of these borrowings the government had to frequently resort to further short term borrowings by issuing Treasury bills. The inflationary repercussions of these borrowings emerged when the Central bank had to take up the majority of Treasury bills that were issued, because public interest in these bill issues were poor. The problem here was that government was borrowing money sometimes from sources that create inflation, to pay for current expenditure and not for capital expenditure.

These socially oriented policies preempted a large amount of funds that could have been used for investment and development purposes even in the government sector. The most vibrant sector up to that time, the agricultural sector was practically dormant and there was little new activity despite the fact that only some sectors in domestic agriculture remained in private hands. Many sectors in the economy, including the plantations, in the seventies were all owned or managed by the government. Due to their overall non viability and other weaknesses, most of them had to be given heavy subsidies, mainly because of mismanagement and low productivity compounded by high wages and a rapidly increasing workforce. Looking at the whole system, it was one that progressively contracted with no prospects of financial surpluses or new sources of revenue emerging. With all these welfare commitments, the only other source of additional funding would have been foreign aid, but aid was at a minimum at that time and there were hardly any independent capital inflows in the form of foreign investment.

Budgetary policy at this time was designed to keep the deficit at a low figure, and in pursuance of this objective the major concern of the government was to increase direct and indirect taxes heavily in order to keep the deficit at a minimum. But this was not always possible because of the welfare commitments and the increasing losses experienced by state corporations and the transfers that had to be made to them. All these became a charge on the budget. The rationing of foreign exchange and increasing import restrictions and exchange controls and higher levels of taxation were the major concern of economic policy. All items of imports were subjected to severe restrictions, while over the twenty year period, exchange control was progressively tightened to the point where hardly any exchange was made available for travel abroad, except for official purposes, which had to have the direct approval of the Prime Minister.

The financial and other economic reforms introduced in late 1977, were designed not only to clearly reverse the adverse results of the earlier package of socialist and restrictive policies on the public finances and the balance of payments but to promote rapid growth and broad based investment. The main focus of the new policies was to obtain the major economic objectives that the government had in view, which was to free the economy from the shackles that had kept the economy hamstrung, to give greater economic freedom to the people and institutions and to allow the private sector to once again take over the large variety of activities which the government had appropriated for itself since the mid 1950s. These were designed to produce a more favourable turn both on the budget and the balance of payments.

In regard to the budget, the new approach was essentially designed to curtail government expenditure as far as possible. This was done by the government relieving itself of certain responsibilities that it had shouldered in the earlier period. While social expenditure on health, education and a few other areas, which were particularly beneficial to the population were not curtailed, the subsidies given to a wide variety of services and government manufacturing corporations which brought in no benefits, other than sometimes, as in the case of transport, making available services to the public at a low price which was far below the cost of the services, were progressively cut down. Recruitment was rationalised, non-economical and non-viable departments were closed down or amalgamated. Both current and capital expenditure were more carefully reviewed and the non essential expenditure pruned drastically.

After 1977 subsidies were sharply curtailed and the subsidies that were continued were properly targeted on the poor. The earlier universal food subsidy programme was replaced with a food stamp scheme which was targeted on the very poor. Progressively the subsidies to government enterprises were cut and after 1988, the government embarked on a large scale privatisation programme and all government economic ventures, both profit and loss making, were sold. The sales of these ventures on the one hand brought in revenue to the government, while once they left the hands of the government, the latter was fully relieved of the commitments to frequently meet their operating losses. Subsidies on all food items, low service sector charges and the subsidies on kerosene were totally removed. The very poor were provided with kerosene stamps. All this was done so that the poor may not be affected by the prevailing high market prices for essential goods. The rationalisation of financial policies does not mean that the earlier policy of welfare was thrown over board. The difference here was that it was properly targeted. But the latter statement has had to be made with some reservations because in the case of health and medical services. there is no targeting as such, because the rich and poor still continue to receive these benefits.

The Economic and Financial Reforms of 1977

The new economic policy of 1977 brought a fundamental change in emphasis from the narrow objective of import substitution, through extensive controls, to an outward looking export oriented industrial development programme. The major push for export led development came from the Greater Colombo Economic Commission that was entrusted with the task of setting up Export Processing Zones. Pricing policies of public enterprises assumed greater importance after the financial reforms, where the objective was to increase commercial profitability through realistic pricing. Greater freedom was given to public corporations to determine prices, even though price changes were subject to approval by the National Pricing Committee. This contributed to substantially improve the financial performance of the public corporations and helped to reduce the dependence of the Corporations on the Budget to finance their losses. The decontrol of imports and the decision to terminate state monopolies in 1977 was designed to improve the efficiency and competitiveness of public enterprises. The liberalisation of imports accompanied by the high tariff structure ranging from 75 to 100 per cent still allowed many state industries to enjoy considerable protection. Furthermore, the continuation of the practice of licensing certain imports also provided profits to certain corporations.

The exchange system underwent a fundamental change in 1977 and this was to have far reaching results on the budget and trade and the balance of payments. The year began with the exchange rate of Rs. 8.72 to the US dollar and on March 12th, the ill advised revaluation of the rupee brought in an exchange rate of Rs. 7.28 per US dollar. As a corrective measure the new government, after July 1977, allowed the rupee to depreciate gradually. This was followed on November 15th by comprehensive exchange rate reforms. The earlier basic rate and the premium (FEEC) rate were unified at an initial rate of Rs. 16 to the US dollar and the rupee was allowed to float. Along with this major financial sector reform, comprehensive import liberalisation was introduced covering all imports, except for the few items which required licensing on account of security, protection, political sensitivity and need to continue government subsidies. A new tariff structure designed to protect local enterprise, while allowing import competition, was implemented at the same time. Imports of capital goods upto Rs. 700,000 were allowed freely. All these represented a basic shift in government policy away from cumbersome quantitative controls towards regulation by tariffs. The earlier stringent exchange controls were liberalised, the various trade monopolies of the state were gradually eliminated and an atmosphere of public and private sector competition was introduced. Scaling down of subsidies was initiated, and as a first step, the consumer food subsidy was withdrawn from those with incomes above Rs. 300/-. In essence, these were the most far reaching economic reforms that the country had ever undertaken.

In regard to imports the Special Import Licence Order No.1 of 1977 specified some 150 items that required licensing thus appreciably reducing the coverage of imports under licence. Apart from the facility to import machinery and equipment up to the value of Rs. 700,000/-, the Revenue Protection Order No. 77/2 introduced the simplified five basic slabs of import duties ranging from 5-100 per cent. A low rate of duty was applied on imports of capital goods, and duty free imports were raw materials that were not produced locally. Higher rates of duties were also introduced to protect certain categories of locally produced goods. On the export side, the new rupee exchange rate gave local producers of exports windfall profits, but government siphoned this off by raising the export duties on tea, rubber and coconut.

The new economic policy arose out of the contention that the continued allocation of large sums of budgeted funds for welfare were not conducive to economic growth and the generation of employment. The rigid restrictions and controls that had been built up over the years had seriously distorted consumer prices and dampened private sector incentives. The public sector, which was encouraged to fill a role that should have been taken by the private sector, had become inefficient, wasteful and complacent. Successive governments had failed to take corrective action, but had resorted to short-term palliatives, which had only compounded the problems. The new philosophy was that more resources should be channelled for future income and employment generating investments.

The liberalisation programme was expected to revive domestic industry by a free flow of raw materials and machinery, by higher capacity utilisation and by greater competition among local enterprises. On the export side, the new exchange rate was expected to provide better incentives, while inducing import substituting industries to look outwards for export markets. In domestic agriculture, the new financial requirements were expected to avoid price distortions and provide greater incentives to increase production. The objective was to promote private business and to discourage the preferential treatment afforded to the public sector; an' monopolies in the state sector were to be done away with.

Foreign investment was encouraged with a view to acquiring higher technology and development of new export markets. Attractive incentives were offered to foreign entrepreneurs and investment in export oriented industries in free trade zones. The inflationary pressures were to be contained by prudent fiscal and monetary policy and by fostering good financial management rather than administrative controls. More funds for development were to be mobilised by offering positive real interest rates. Inflationary pressures in the short run were to be kept in check by sharply increasing interest rates.

The budgets were going to be designed to curtail subsidies and to progressively divert resources from consumption to investment. The latter was to be achieved by limiting general consumer subsidies which were thereafter to be targetted to the most needy. The tax system was reorganized to restore investment and production and the investment climate was to be improved by ensuring political and economic stability. The current account deficit that was likely to emerge in the balance of payments during the medium term of economic transformation as a result of import liberalisation, was to be met by greater mobilisation of external assistance. These policies envisaged a movement away from the tightly regulated inward looking and welfare oriented policies of the earlier period.

The Early Impact in 1977

The background events, especially on the balance of payments side, for the liberalisation programme were very favourable. A better time could not have been selected to launch the programme in an economic context. The improved trade position in 1977 was due to a remarkable turn in the terms of trade in Sri Lanka's favour for the second successive year. Sri Lanka's terms of trade which had continuously deteriorated since 1965 showed an improvement of 35 per cent in 1976 and improved further by 31 per cent in 1977. A part of this was due to the unprecedented increase in tea export prices, about 80 per cent of which was due to the continuous improvement of world tea prices. In 1977, therefore, there was a trade surplus of Rs. 631 million as compared to a surplus of Rs. 170 million in 1976. The balance of payments showed a turn around from deficit of Rs. 50 million in 1976 to a very large surplus of Rs. 1259 million in 1977.

The rupee value of export earnings rose from Rs. 4.7 billion in 1976 to Rs. 6.6 billion in 1977, showing an increase of 41 per cent. The rupee value of import payments increased from Rs. 5.4 billion in 1976 to Rs. 6.1 billion in 1977 or by 14 per cent. In 1977 the net inflow of long term capital increased, consisting of project loans of Rs. 379 million, commodity loans Rs. 342 million, food aid Rs. 269 million and other aid Rs. 141 million, totalling Rs. 1184 million. The outstanding total foreign debt increased more than two fold from Rs. 6.8 billion in 1976 to Rs. 13.3 billion in 1977 and this increase was mainly due to exchange rate changes.

Government revenue in the fiscal year 1977, was Rs. 6.6 billion showing an increase of 17 per cent over 1976 and this resulted from the siphoning off of a part of the export receipts and the relatively higher surpluses on imports. The tax rate applicable to the tea industry was revised in 1977 in order to recoup the higher export earnings that resulted from the fall in the value of the rupee.

In late 1977, a fundamental change in interest rate policy took place. Earlier Sri Lanka had for many years followed a low interest rate policy. The highlights of this new financial measure was to sharply increase the time and savings deposit rates of the National Savings Bank which was followed by similar changes in the deposit and lending rates of commercial banks and an upward movement in the Treasury bill rate. However, in 1978, both Bank rate and the Treasury bill rate remained unchanged at 10 and 9 per cent respectively. It was designed to increase the rate of savings and to mobilise more savings for the extensive investment programme that lay ahead. Credit was to be made more expensive reflecting the scarcity of resources and the necessity to divert credit to priority areas. Furthermore, in a liberal import atmosphere low interest rates may have stimulated consumption and speculation. Although lending rates of the commercial banks remained high throughout the year, there was no evidence to show that the demand for credit by the private sector had been adversely affected. On the other hand, in 1978 there was a record increase in private sector credit. A significant feature after the 1977 interest rate reform was a sharp acceleration in the rate of deposit mobilisation by institutions. The increased mobilisation of deposits helped to sharply decelerate the rate at which money supply increased.

The Impact in 1978 and 1979

The buoyancy of the economy and the resurgence of economic activity resulted in a growth rate of 8.2 per cent in 1978. However, during the year, the earlier commodity boom had subsided and the surplus in the balance of payments in 1977 turned out to be a deficit in 1978. But despite this, in 1978, substantial inflows of resources from the International Monetary Fund helped to create a favourable overall balance in Sri Lanka's payments, augmenting external assets in the third successive year. The level of external assets in 1978 was adequate to meet about four months of imports projected for the year. This spectacular revival of the economy in 1978 could be attributed to the financial and economic reforms initiated in 1977. Fundamental to this was the adoption of a realistic exchange rate and abolishing the overvalued currency system which was maintained by stringent exchange restrictions. This enabled the government to relax trade and payments controls and to move away from quantitative restrictions to tariffs, as a means of protecting domestic enterprise.

Trade policy in 1978 was directed towards promoting exports, dismantling licensing and reforming the tariff structure and control procedures. Import duties were reduced on a number of commodities while penal rates were applied on luxury consumer goods. The performance of the balance of payments in 1978 was heavily influenced by the economic reforms of 1977. The immediate impact of these measures was seen when the country's balance of trade account shifted to a deficit from a surplus in 1977. Despite this, external assets increased further in 1978 and at the end of the year they were sufficient to finance four months imports in 1979.

The increase in external assests was mainly due to the heavy inflow of long term capital and drawings from the International Monetary Fund. The impact of the liberalisation was sharply felt in the case of imports. The import bill increased from Rs. 6290 million in 1977 to Rs. 15,350 million in 1978. The increase in imports reflected the release of pent up demand built up over the years of controls. The rise in imports was mainly in investment and intermediate goods, while imports of consumer goods rose at a lower pace. The more than two fold increase in imports of capital goods in 1978 partly reflected the bottlenecks that had existed in domestic industries for a number of years.

Although import payments increased sharply in 1978, it was much less than was originally expected.

The reason for this was that the rise in import prices after the depreciation of the Sri Lanka rupee tended to moderate the demand for imports. Secondly, the tightening of bank credit was an anti-inflationary measure, that made less money available to finance imports. Thirdly, some of the imported goods did not move quickly in the local market as importers were unable to assess the market accurately. Fourthly, after a long period of restrictions it took some time for importers to organise themselves to cope with the new system and to reestablish trade and commercial contacts

In contrast, export earnings increased by 4 per cent from Rs. 6.6 billion to Rs. 13.2 billion while imports went up sharply by 23 per cent. The actual increase in exports was marginal because the depreciation of the rupee tended to inflate the figures. Therefore in SDR terms the increase was from SDR 651 million in 1977 to SDR 675 in 1978. This was mainly due to the fact that the production levels in the main export industries had remained stagnant for a long time. However as in the previous year earnings from tea continued to increase reaching SDR 52 million which was an increase of 40 per cent. The services account showed a lower surplus in 1978, having declined from Rs. 304 million in 1977 to Rs. 119 million in 1978. After the relaxation of exchange controls, expenditure by Sri Lankans travelling abroad for business, export promotion and other purposes increased sharply from Rs. 33 million in 1977 to Rs. 444 million in 1978, while the gross earnings from tourism rose from Rs. 304 million to Rs. 750 million. Inward remittances by Sri Lankan workers, mainly in the Middle East, increased three-fold from Rs. 190 million in 1977 to Rs. 610 million in 1978. The balance of payments in 1978 showed a surplus in its basic balance for the third successive year. The surplus of Rs. 1858 million in the basic balance was in contrast to the current account deficit of Rs. 1032 million and reflected a heavy inflow of long term capital. Long term capital inflows more than doubled to the unprecedented level of Rs. 3680 million and was the largest increase ever recorded. Due to the inadequacy of domestic financial resources for development the inflow of external capital was a significant feature.

In 1978, the gap between total payments and receipts in the balance of payments more than quadrupled to Rs. 4,048 million. This was in contrast to the previous year 1977 when the resource gap of Rs. 860 million was much smaller. In 1976, the resource gap was cut down to Rs. 252 million through controls and restrictions. The improvement in the balance of payments in 1977 was due to a sharp increase in export earnings, but the gap between exports and imports widened in 1978 due to the slackening of exports and a much higher level of imports and this was due to the policy of liberalisation. In 1978, the resource gap was almost entirely financed by long term loans. The policy of trade and payments liberalisation through appropriate changes in exchange rate policy and a floating exchange rate system enabled a free flow of imports to the most needy sectors of the economy and this helped to remove the bottlenecks that had existed under the earlier system of trade controls. Resources were allocated more efficiently through the price mechanism rather than through administrative fiat and this resulted in higher growth rates and more employment.

In line with the government's policy of making state industrial enterprises commercially viable, the dependence of these enterprises on government funds declined considerably in 1978. The total amount of funds transferred to industrial corporations came down from Rs. 1,485 million in 1978 to Rs. 300 million in 1979. Many corporations had to increase prices in order to meet the increasing cost of production and these included Petroleum, Cement, Steel, Ceramic and Hardware. The sharp increase in commercial activity resulting from the new financial policies of 1977 exerted pressure on the economic infrastructure and social overheads throughout 1978 and 1979 and this created additional demands on the government budget. Infrastructure facilities as well as certain categories of skilled man power were in short supply. These defficiencies contributed to worsen inflationary tendencies in 1979 as they stood in the way of achieving higher levels of production.

The upward movement of prices that took place in the second half of 1978 was due to the substantial depreciation of rupee, the removal of the rice and sugar subsidies from a large proportion of households, the increase in wages in the private and public sectors in December, 1977, the upward revision of the price of wheat flour and the increased balance of payments surplus during the year. The price increase in 1978 was 12.1 per cent. This increase would have been even higher had it not been for certain factors, particularly the increased supply of imported goods after liberalisation, more competition in the import and the distribution markets, improvement in transport facilities and higher production of major consumer goods particularly rice, and the lowering of the Business Turnover Tax and import duties on many items.

As it was with the balance of payments, the economic reforms of 1977 had a very clear impact on the level and direction of government finances in 1978. Changes in prices, the widening of the tax base, adjustment of tax rates and higher expenditure, almost doubled the size of the budget. The ratio of recurrent expenditure to GNP rose from 23 per cent in 1977 to 34 per cent in 1978, while capital expenditure rose sharply to 15 per cent. Government revenue in 1978 was Rs. 11,633 million which was an increase of 74 per cent over the 1977 level. Export duties increased nearly eight fold and accounted for nearly 30 per cent of the revenue for the year and this could be attributed largely to the increase in tax rates and the enhanced tax base following the exchange reform. Revenue from the Turnover Tax which declined marginally in 1977 increased by 62 per cent owing to the increase in business activity in the private sector and the collection of tax arrears.

The full impact of the trade liberalisation measures of 1977 was felt in 1979. The devaluation of the rupee and the upward revision of tariffs continued to make imports costly. Import prices rose by 52 per cent, but despite higher prices for goods there was a heavy demand for imports which went up by 37 per cent. Given the strong pent up demand, the high level of imports in 1979 can be considered as an outcome of the uninhibited impact of removing restrictions. On the other hand, through a more attractive exchange rate and the free availability of inputs exports tended to increase, although initially at a slow rate; substantial results took several years to materialise. The rise in exports in SDR terms in 1978 was 2 per cent and in 1979, it was 12 per cent. It was therefore natural not to expect exports to rise at the same rate as the imports during the first few years of the new policies.

The aim of trade policy was to regulate economic activity through prices rather than through quantitative restrictions and exchange controls. This was largely done through the revision of import duties and export duties. It helped to make the mechanisms of regulation more efficient and to reduce malpractices and distortions arising from the earlier system. In particular, duties on exports were revised downwards with a view to promoting exports. The Presidential Tariff Commission, which was established after trade liberalisation as a permanent institution was entrusted with the task of reviewing tariffs. The protection of local industries through higher duties raised prices and this was in conflict at that time with the interests of the consumers, not only in the case of consumer goods, but also, for some intermediate goods.

The aim of fiscal policy in 1979 was mainly to rationalise and consolidate the objectives of the economic reforms with a view to promoting capital formation and savings. The government granted generous investment reliefs, lump sum depreciation and capital allowances to investors and at the same time, handsome export tax reliefs were given to the tea and the coconut industries. With regard to expenditure, the ratio of government expenditure to GNP declined by 3 per cent to 44 per cent, while the share of capital expenditure increased from 16 to 18 per cent and the share of current expenditure declined from 31 per cent to 26 per cent.

In 1979 the food subsidy continued to be the largest single item in recurrent expenditure. In accordance with the financial reforms, in order to rationalise the expenditure on subsidies, the food subsidy scheme was withdrawn and in its place the food stamp scheme was introduced in 1979. Under the food stamp scheme the direct transfer of income was made to the household. Total government revenue amounted to Rs. 12.3 billion showing an increase of 9 per cent over the previous year. The emphasis in the tax collection effort was placed on indirect taxes. Import duties assumed the role of bringing in the major portion of budgetary revenue. Taxes on external trade brought in 55 per cent of total revenue. Export duties were the largest single source of revenue, but receipts from export duties declined due to a reduction in the export tax. However, the flow of imports continued to expand and revenue from duties rose significantly. The average effective rate of duty was about 10 per cent. The enhanced volume of trade helped to increase receipts from the Business Turnover Tax, but the receipts from the Turnover Tax on manufacturing declined slightly.

The higher level of economic activity raised collections from corporate income tax, but substantial reliefs on personal income led to a virtual stagnation of revenue from that source. In 1979, current transfer payments amounted to Rs. 6.5 billion which was an increase of Rs. 1.3 billion. Transfer payments were 56 per cent of total current payments. Food stamps were given to households in receipt of a monthly income of less than Rs. 300/-. Those in receipt of an income of more than Rs. 300/- and less than Rs. 750/- per month were entitled to receive food stamps depending on the size of the family and income. Each family unit eligible for food stamps was also entitled to kerosene stamps worth Rs. 95/- per month. The relative share of the food subsidy in total transfer payments was 36 per cent. However, in an absolute sense, in spite of the food stamp scheme, the food subsidy bill increased by Rs. 163 million due to higher import prices of food stuffs.

The total expenditure on subsidies of Rs. 2.4 billion included a payment of Rs. 70 million to green leaf tea producers and a fertilizer subsidy of Rs. 431 million. Interest payments on the public debt at Rs. 1.7 billion showed an increase of 24 per cent and accounted for 26 per cent of the total transfers. In 1979 interest payments on the domestic debt was Rs. 1.2 billion and on foreign loans Rs. 427 million. More foreign lines of credit and domestic borrowings were necessary to meet the higher levels of expenditure in the government budget in regard to both current and capital expenditure. Furthermore, the devaluation of the rupee and the resulting higher prices had contributed to inflate all categories of expenditure.

The actual net cash deficit of the government was Rs. 7.6 billion which was an increase of Rs. 2.6 billion over the original estimate and included an increase of Rs. 768 million in recurrent expenditure and Rs. 1942 million in capital expenditure. In 1979, the net receipts from foreign sources to finance the budget deficit was Rs. 3.7 billion and this was Rs. 215 million lower than the receipts in the previous year. For budgetary purposes a net sum of Rs. 2.3 billion was obtained from non banking domestic market sources. Net borrowings from the banking sector amounted to Rs. 662 million consisting of provisional advances of Rs. 181 million and subscriptions to Treasury bills Rs. 556 million. Government fiscal operations in 1979 resulted in a monetary expansion of Rs. 634 million when compared to 173 million in 1978.

Even though Sri Lanka achieved a statisfactory rate of economic growth in 1980, however, the difficulties in the balance of payments and the government budget did not show any improvement. It was evident from the experience of the preceding years that relief was only forthcoming if Sri Lanka's export commodity price rose in the international markets. This of course would have a favourable effect on both the balance of payments and the budget. But as far the budget and the balance of payments were concerned because of the very ambitious economic development programme undertaken by government, even in years when commodity prices were good and the terms of trade were favourable, the level of domestic savings and the foreign exchange available to the country have been barely sufficient to meet the development needs.

In 1980, with the fall in commodity prices the terms of trade deteriorated once again and caused heavy deficits in the merchandise and current accounts of the balance of payments, thus resulting in heavy losses in external reserves and leading to a further depreciation of the rupee. The deficit in the merchandise account at Rs. 16.3 billion was the highest up to that time and represented a sharp deterioration over the deficit of Rs. 7.2 billion in the previous year. Apart from the unfavourable terms of trade, another factor which put enormous pressure on the balance of payments was the increase in the volume of imports to meet the needs of a sharply expanded investment programme. In the face of this, import prices rose sharply and part to it was due to the fall in the external value of the rupee. It was also the first time since 1976 when Sri Lanka's external reserves showed a very sharp decline. The developments in the balance of payments in 1980 reflect the attempt made to absorb more resources than it could generate internally and those it could obtain from outside. Since accumulated reserves have been brought down to a critically low level, the country's ability to borrow in international markets became more difficult. Sri Lanka's external assets dropped to SDR 179 million in 1980.

As with the balance of payments, the developments in government finances in 1980 were heavily influenced by the strains and stresses of an ambitious development programme. The emphasis was placed on a much higher level of economic activity spearheaded by the lead programmes which involved large sums of money for investment. The government was endeavouring to make a big push by this means within the framework of the open economic policy. In the preceding years the demand for consumption and investment stimulated by these policies had a major impact on the balance of payments and the government finances. It was in 1980 that many of the lead projects gathered momentum and accordingly claimed a higher share of the resources, and in that background, the objectives of government finance displayed a fundamental conflict of interest. On the one side, the government had to restrain the unfavourable effects of rising demand in the economy and on the other, it had to achieve a greater measure of fiscal stabilisation and preferably a balance of payments surplus. Thus objective could not be achieved in the background where investment projects were gathering momentum and requiring more and more resources. It meant that many government agencies, relevant departments and state ministries had to meet unprogrammed expenditure, partly due to the speed at which projects were undertaken and the cost overruns which emerged in a situation where both local and international prices of goods and services were rising.

In this background, developments in the international money market in 1980 were not favourable because government was unable to borrow easily. The flow of foreign resources was inadequate to finance the widening government deficits. Being caught up in a resource constraint of this magnitude the government had no alternative but to resort to commercial borrowings on an unprecedented scale. The enormous demand for the resources strained the absorptive capacity of the economy and exerted pressure on consumer prices and the money supply on the one side, and on the other, on the exchange rate and the balance of payments. The lack of resilience in revenue in relation to the increasing income levels to a great extent was attributable to a variety of concessions, mainly in the form of lump sum depreciation allowances given for non traditional economic activities. The share of capital expenditure in GDP rose from 18 per cent to 22 per cent, while in absolute terms capital expenditure increased by 54 per cent.

The growth momentum achieved in 1980 despite the difficulties that confronted the economy in that year was commendable. Sri Lanka had witnessed very large increases in investment since 1978, and no doubt, these were slowly but steadily contributing to visible structural changes in the economy. The most dynamic growth was in the garment export industry. However, in the early nineteen eighties, when recession dominated many of the industrial countries with rising unemployment, high energy costs, increasing interest rates, inflation, volatile exchange rates and very slow growth of world trade, Sri Lanka's export oriented growth strategy had to be tried and tested in this not entirely wholesome economic environment. However the Sri Lanka economy in the first five years of its open economic policy, was able to show a remarkable resilience. The investment programme was only partly fiananced by local savings, while borrowings had to come from foreign sources and the high level of investment that was sustained since 1977 was achieved by incurring large deficits in the balance of payments.

Although the government made maximum efforts to mobilise additional revenue, the difficulties that the government faced were the adverse trends in export prices which resulted in a downward revision of export duties and a further depreciation of the exchange rate. The second factor was that tax revenue had shown very little elasticity in responding to inflationary trends in the economy between 1977-81. With inadequate growth in revenues in the face of a heavy investment programme and with escalating prices, the size of the budget deficit had tended to increase. Even the increasing levels of foreign assistance and borrowings from non bank sources were therefore inadequate to cover these growing deficits. Furthermore, the public sector had to compete with the private sector for resources. The problem of managing demand became more acute, because private sector investment had a relatively lower gestation period than in the public sector. As a result, the government had to increasingly resort to more expensive forms of financing the budget. Commercial borrowings increased sharply at that time when international interest rates remained at a high level. While such financing helped the government not to have recourse to the banking system to finance the budget deficits, on the other hand, it created serious debt servicing problems.

In 1981, Sri Lanka's economic performance, showed a significant improvement over 1980. In the latter year, a substantial imblalance tended to develop in the fiscal operations of the government which resulted in a large deficit in the balance of payments. Due to better management of expenditure the budget deficit declined from 24 per cent of GDP in 1980 to 17 per cent in 1981 and the current account deficit in the balance of payments from 16 per cent of GDP to 11 per cent. These improvements were due to the wide range of measures which included a reduction and tighter control of public expenditure and complementary monetary measures. In April 1981, the Central Bank commenced open market operations in the Secondary Treasury bill market with the object of mopping up excess liquidity and promoting an active market in Treasury bills. The Central Bank's sales of Treasury bills to the banks in the secondary market were made through money and exchange brokers. During the year Certificates of Deposit were introduced by some banks with the intention of absorbing 'black money'. There were also rediscounting facilities of Certificates of Deposits made available by the banks.

When compared to 1980, Sri Lanka's balance of payments in 1981 improved considerably. There was a deficit of Rs. 2967 million in 1980 and in 1981 it was reduced to Rs. 406 million. Better controls on spending and flexible exchange rate policies were helpful in reducing the trade deficit on current account. There were larger inflows both in the current and the capital accounts, and private remittances and official transfers predominated. The capital inflows were foreign loans including assistance from the IMF, direct investments and short term borrowings. A notable feature of financing the deficit was increased resort to commercial borrowings both by the government as well as public sector corporations, despite the availability of funding from conventional sources in the form of foreign loans, grants and drawings from the IMF. A rationalised import duty structure was put into effect in 1981. Import duties were broken up into a protective component and a revenue component with the turnover tax predominating. The new tax structure made customs duties more effective as a means of protection for domestic industry and proved to be useful for balance of payment purposes as well. The then existing import tariff structure was mainly an ad hoc exercise undertaken before 1977. Since then, no rational attempts had been made to assess the consequences of protection for industry implied in the existing tariff structure. During the year export duties on tea, rubber and coconut were scaled down at a considerable cost to revenue to ensure adequate margins to producers. The coconut export trade became the major beneficiary of the deregulation of the export trade.

The fiscal policies of the government in 1981 were aimed at improving budgetary management. Prudent demand management policies were introduced and a 25 per cent expenditure cut was enforced in the 1985 budget. In addition, a further reduction of both recurrent and capital expenditure was imposed during the year, including a 3 per cent reduction in recurrent expenditure and a 10 per cent reduction in capital expenditure. All ongoing and proposed projects were rephased. The deficit of Rs. 14,873 million wss financed from resources obtained from domestic and foreign sources. Domestic sources financed 44 per cent and the balance 56 per cent was from foreign sources.

Total government expenditure in 1982 was Rs. 38 billion which was 23 per cent higher than in 1981. As a percentage of GDP at current prices it increased from 36.6 to 38 per cent in 1982. Recurrent expenditure rose by 8.5 per cent to Rs. 19.2 billion, total revenue was Rs. 17.8 billion, which was a 10 per cent increase, and the budget deficit was Rs. 1,421 million. Foreign resources which amounted to Rs. 9.2 billion contributed to finance 46 per cent of the deficit. The investment in the Context of an outward looking growth strategy, was to be sustained initially by foreign savings, and thereafter, by strengthening the balance of payments in the medium-term through an expansion of exports. The export sector virtually stagnated in 1982 and the current account deficit was as high as 13 per cent of GDP, while the debt service ratio also increased sharply.

The important change in the composition of Sri Lanka's imports since 1978 has been the increase in the share of intermediate and investment goods. The increased production of rice and other subsidiary food crops was partly due to better prices which producers obtained with the removal of subsidies and this contributed to the decline in the share of consumer goods imports. Even with all these measures, on the import front, the imports necessary to sustain the economy continued to be high and the only way to balance it was by accelerating exports.

The prospects of an increasing debt service burden, peaking of the inflow of private remittances and the bleak outlook for concessional aid added a sense of urgency to this task. However, the objective of accelerating exports was not easy in the context of an international environment where sluggish growth with rising unemployment in the industrial countries kept down the demand for imports. In addition, recessionary conditions in the industrial countries led to the strengthening of protectionist tendencies. Apart from their impact on exports, the fiscal and monetary policies, in these countries resulted in high nominal and real rates of interest that added to Sri Lanka's debt service burden, even in respect of borrowings made from international lending institutions.

By 1982, Sri Lanka had completed five years of its programme of economic reforms designed to liberalise the economy on the basis of an outward looking strategy. The past five years have seen much progress in this direction. The most notable success had been the country's ability to break out of low investment and low growth of the pre 1977 period. However Sri Lanka's export oriented growth strategy after 1980 had to be tried and tested in a somewhat hostile economic environment. The fact that economic growth continued to be sustained in the face of adverse developments is undoubtedly noteworthy. The doubling of petroleum prices which led to substantial increases in the import bill, the recession which reduced export demand, government revenue and aid flows and international inflation which led to the continuous deterioration in the terms of trade, and the cost escalations in the public investment programme of the country, were developments which had an overwhelming impact on the country's savings and investment record and on its balance of payments and budgetary performance.

Even so, Sri Lanka's growth rate of real GDP had averaged 6.2 per cent in the period 1978-1982. The public sector through the public investment programme, as well as the private sector, which was freed of most controls, have contributed to the growth effort which has been accompanied by significant gains in employment. Sector-wise, the most impressive real growth was achieved in agriculture, particularly in paddy, and to some extent in industry. However, lack of progress in tea crop production and the export sector in general has been a disappointing feature. In addition the high levels of investment in the face of an inadequate increase in domestic savings, though sustained by concessional aid flows, have also resulted in increased resort to foreign commercial borrowings, a draw down of reserves and a depreciation in the exchange rate. The impact of the increase in the levels of domestic investment has been a higher rate of price increase, escalating costs of investments; and in the face of continued inflationary trends, the lack of any significant increases in savings, implying the shift of resources from investment to consumption. The implementation of effective demand management policies, nevertheless helped to restore a better balance in the economy. The acceleration of the rate of growth in exports, which was one of the major objectives of the economic and exchange rate reforms, was only partially achieved.

In 1983, developments in external trade were more favourable than in the years prior to that. This was mainly the result of the gradual recovery of the developed countries from the recession as well as from the unprecedent rise in tea and rubber prices. In SDR terms imports which had increased steadily in earlier years declined by 1 per cent, while exports increased by 7 per cent as compared with the increase of 13 per cent and 0.6 per cent respectively in imports and exports in 1982. For the first time since the introduction of the liberalised trade policy in 1977, the value of total imports declined marginally. However, imports other than petroleum, increased by 15 per cent in SDR terms indicating a steep rise in expenditure on food and other consumer goods.

In 1983, prices of Sri Lanka exports increased by 39 per cent in contrast to a decline of 8 per cent in 1982. On the other hand, import prices increased by 21 per cent as compared to a 10 per cent increase in 1982. The country's terms of trade improved by 16 per cent. This was accompanied by a major change in the composition of imports. There was an increase in the share of consumer goods and a decline in the share of intermediate and investment goods. The share of consumer goods imports increased from 21 per cent in 1982 to 26 per cent in 1983. But the share of intermediate and investment goods fell from 52 per cent to 48 per cent and from 28 per cent to 27 per cent respectively. Export earnings accounted for 55 per cent of total foreign exchange earnings and had financed only 21 per cent of total imports.

In 1983, Sri Lanka's export performance was very much better than in 1982, but it had some unsatisfactory features. The increase in exports was mainly due to the high price of tea and rubber, which more than compensated for the large declines in their volumes. Export volumes declined despite the variety of incentives provided for export development under the liberal economic programme. The higher earnings from exports and the reduction of expenditure on imports resulted in a smaller deficit in the balance of trade in 1983.

The deficit in the current account which reached the record level of Rs. 11.9 billion in 1982 came down marginally to Rs. 11.1 billion. In 1983, the current account deficit decreased to 9.4 per cent of GDP while it was 11.9 per cent in 1982. Sri Lanka did not get the full benefits of the improvement in the terms of trade because of the decline in export volumes, particularly tea, as compared to the previous year. The massive on-going programme of investment involved a large amount of foreign borrowings which resulted in heavy debt service payments, which were aggravated further by an increase in short term commercial borrowings. In addition, civil disturbances in July 1983 resulted in a decline in receipts from tourism, which created further problems for the balance of payments.

The external resource gap, which is the difference between total foreign exchange receipts and payments, including short terms credits, increased by 3 per cent in 1983 as compared to the increase of 14 per cent in 1982. When imports are excluded the external resource gap in 1983 was Rs. 23.3 billion as against Rs. 22.5 billion in 1982. But on the whole, there was relatively less pressure on the balance of payments in 1983.

A dynamic fiscal policy had helped to sharply accelerate economic growth since 1977. However, the high level of government investment which resulted in an excessive budget deficit and a considerable amount of bank borrowings since 1978 led to new pressures on the economy. In order to meet this challenge, adjustments in the fiscal front were a formidable task. On the revenue side, unfavourable international markets for exports until mid 1983 and tax concessions and incentives for savings and investment contributed to an erosion of the revenue base. On the expenditure side, government was committed to sustain a higher rate of growth in the economy accompanied by a large amount of public sector investment. The servicing of the sizeable budget deficits increased government expenditure through large debt service payments. Moreover, the poor performance of public enterprises aggravated the efforts made to work towards a balanced budget.

Faced with these difficulties, the initial effort was focussed on cutting down expenditure by restricting government expenditure on on-going projects and rationing expenditure on other items. On the revenue side adjustments were made by removing some of the tax concessions and incentives and the introduction of new revenue measures. Accordingly, the period since 1981 witnessed a gradual improvement of budget operations with the object of the better management of the economy. The total estimated expenditure was Rs. 28 billion and capital expenditure was Rs. 18.9 billion. The overall deficit was Rs. 16.5 billion and the deficit was financed by Rs. 12.3 billion from foreign sources and Rs. 4.2 billion from domestic sources.

The Impact of Policy 1984 to 1988

In 1984, Sri Lanka was able to attain a growth of over 5 per cent for the second successive year and the major contribution to economic growth came from manufacturing industry. Industrial output rose sharply by 15 per cent and this improved performance was seen in the private sector which contributed 26 per cent while the contribution of public sector industry was 7 per cent. These achievements took place despite the serious disturbances which occurred in 1983. Much of the output of the private sector industry which consisted largely of textiles and garments and other industrial goods was exported. The continuing improved performance of private sector manufacturing industry was the positive response of the industrial sector to the on-going liberal economic policies and the attractive package of incentives given by the government. There was a considerable improvement in the management of the government finances in 1984 and it was a continuation of the approach adopted in 1983. Revenue collection went up sharply while public expenditure slowed down helping to reduce the budget deficit. In relation to GDP, the budget deficit fell from 18 per cent in 1983 to 11 per cent in 1984.

The increase in the budgetary savings that year was in the region of 4 per cent of GDP and accounted for nearly half of the domestic savings. Government revenue increased by 50 per cent in 1984 and revenue as a percentage of GDP rose from 21 per cent in 1983 to 25 per cent. During the year, revenue mobilisation efforts were greatly strengthened and in particular, revenue from non tax sources went up. On the expenditure side, government took action to cut down spending and to improve the management and working of public sector corporations, to some extent however, this was offset by so many supplementary expenditure estimates which were approved during the year. In 1984, government depended heavily on foreign savings to meet the deficit. The foreign financing of the deficit rose from 51 per cent in 1983 to 71 per cent in 1984.

International economic conditions improved sharply in 1984. The strong recovery in the USA gave a boost to production world wide. This was also accompanied by a decline in the rate of inflation in most industrial countries which averaged about 5 per cent. However, low inflation rates and increased unemployment strengthened protectionsim in these countries, which in turn, hindered the expansion of world trade. While Sri Lanka benefited from better commodity world trade conditions, at the same time, there was a substantial drop in the prices of several import items. As a result, Sri Lanka's terms of trade improved by 14 per cent following the increase of 16 per cent an year earlier. On account of all these factors, Sri Lanka's balance of payments position in 1984 was extremely favourable. The salutary effects came from tea exports which rose by 83 per cent in SDR terms and accounted for 42 per cent of the total value of exports. Combined earnings from tea, rubber and coconut rose by SDR 291 million. However, Sri Lanka was not able to reap the full benefits of high commodity prices due to the inability to increase production rapidly.

The deficit in the merchandise account of the balance of payments fell dramatically to Rs. 10.1 billion from 20.1 billion in the previous year. At the same time, the deficit in the services account showed a smaller deterioration than in 1983 and this deficit was mainly due to the interest payments on the foreign loans as well as the decrease in the receipts from tourism. The current account deficit fell from 9.1 per cent of GDP in 1983 to 0.5 per cent in 1984. Nearly 95 per cent of the deficit on goods and services was covered by inflows of foreign exchange both as private and official transfers. The actual inflow of non monetary capital was much more than the current account deficit and therefore, overall, there was a much higher surplus and this surplus was SDR 297 million in 1984 compared to SDR 0.6 million in 1983. The economic performance on the whole in 1984 was very satisfactory and achievements in several areas outstripped expectations. Even so the encouraging outturn was largely due to the favourable turn in the terms of trade which closley influenced both the balance of payments and the budget.

In 1985, the balance of payments deteriorated sharply and this was reflected in the current account as well as in the overall balance. The deficits in the merchandise and services accounts widened, while net private transfers decreased marginally and official transfers showed a substantial drop. As a ratio of GDP, the current account deficit increased from 0.8 per cent in 1984 to 7.2 per cent in 1985, while the deficit in the services account nearly doubled in SDR terms. The net outflows of foreign exchange on account of port, transportation and insurance were less but the fall in net foreign exchange earnings from tourism and other out payments enlarged the deficit in the services account. In 1985, interest payments, continued to be the largest debit item in the services account.

In 1985, the trade deficit widened by Rs. 7.385 million or SDR 240 million. This deterioration was the result of a 9.5 per cent decline in export receipts and a 5.6 per cent increase in import payments. A drastic decline in export earnings from tea and rubber was mainly responsible for the drop in total export receipts. This shows that within a broader framework of a liberal economic policy, export and import performance is a significant factor that determines the balance of payments outcome. The beneficial effects would be present only if the liberalisation programme was able to rapidly diversify and push exports sharply to high levels. In the case of products like tea and coconut, sometimes, the over production of these items tends to bring down international prices and therefore to produce an unfavourable result in the terms of trade. To counter this trend, new exports with sustained markets and better prices are necessary.

In regard to the latter, the diversification effort for exports had not made adequate progress and the new economic programme had led only to a limited number of new exports. Notable in this field was the expansion of textile and ready-made garments which has shown a continuous increase since 1977. But in 1985, garments exports declined by 1 per cent, while exports of other products increased by 2.6 per cent. However, their earnings from non traditional exports increased in 1985 by 8.7 per cent and the share of these exports in total export receipts rose to 53 per cent in 1985 from 45 per cent in 1984. During the year imports of consumer goods, intermediate goods, and defence related goods increased while investment goods declined.

The services account of the balance of payments continued to be in deficit in 1985 for the fourth year in succession. Foreign exchange payments on services increased by 14 per cent, while receipts declined by 2 per cent resulting in a new deficit of Rs. 3573 million in 1985 as against a deficit of Rs. 1735 million in 1984. Higher interest payments on foreign loans, decreased earnings from tourism, higher payments on account of foreign travel and increased government expenditure abroad were responsible for the larger deficit in 1985. During the year, tourism received a set back when tourist arrivals declined by 19 per cent and earnings fell by 18 per cent, mainly due to unsettled conditions prevailing in the country. The liberalisation programme resulted in foreign exchange payments on account of Sri Lankans travelling abroad continuously rising rapidly. Furthermore, the liberalisation programme provided for the repatriation of profits, dividends and interest payments and these items continued to be a substantial drain on the services account. This drain was only partly off-set by higher interest earnings from investments of external assets abroad.

The maintenance of stable prices had throughout been a major objective of budgetary policy. Government was mindful of the need to keep total expenditure within the available resources in order to reduce the budget deficit. Unlike in the previous year, even though commodity prices fell sharply in 1985, government revenue as a proportion of GDP remained unchanged at the previous years level of 24 per cent, because revenue augmentation measures helped to off-set the adverse effects of the reduction of import taxes on government revenue. However, more expenditure on defence activities and higher debt service payments resulted in the ratio of total expenditure to GDP rising to 40 per cent in 1985 from 35 per cent in 1984. Although Government's intention was to keep expenditure on welfare services and transfers to institutions and households to a minimum, the latter figure still amounted to Rs. 3345 million, an increase of 10 per cent. These transfers included a subsidy on interest paid by the National Savings Bank of Rs. 495 million, welfare payments made by the Department of Social Services Rs. 133 million, free text books for school children Rs. 155 million, the mid day meal for schools Rs. 31 million and holiday warrants to government employees Rs. 99 million. The total expenditure on the subsidy on infant milk food and kerosene and food stamp schemes were Rs. 1828 million, showing a decline of 3 per cent. Current transfer payments, to government corporations amounted to Rs. 1370 million in 1985, which was 27 per cent less than in the previous year.

A problem associated with budgetary management was that even with the efforts made to find additional revenue from new sources and the steps taken to curtail welfare expenditure, new items of welfare expenditure emerged, and as a result, it was not easy for the administration to reduce the budget deficit. Mainly with a view to reducing the effects of the new economic policy on the lower income groups, welfare expenditure had to be maintained while focussing such expenditure more specifically on the poor and the needy. Had this aspect not been taken into consideration, which would have meant that there would have been much less welfare expenditure, then the question of reducing the overall deficit in the budget would have been relatively easy. In this balanced programme of development equal weightage had to be given not only to more investment and adjustments under the liberal economic policies, but equally, to welfare programmes that will protect the incomes and living standards of those who are likely to be affected by the adverse income distribution effects of liberalisation.

For the second successive year, unfavourable trends were present in Sri Lanka's external trade in 1986. The value of exports fell sharply by 25 per cent, showing the highest decline in that period. However, the adverse effects of lower export earnings were mitigated by lower prices for crude oil, fertilizer, wheat grain and sugar, and as a result, import payments fell by 15 per cent in SDR terms as compared to an increase of 7 per cent in the previous year. Earnings from exports of tea and coconut fell even though there were increases in the volume of these exports. There was a notable change in the composition of exports and imports in 1986, and in regard to exports, the share of industrial and mineral products increased, while the share of agriculture came down. An important feature was the fall in the share of tea, an export, which had traditionally been the largest single item, while garments for the first time took precedence. On the import side, textiles topped the list, overtaking petroleum which up to that time had been the largest single import item.

Following the trend in the preceding years, exports continued to make a modest contribution to promote a healthy balance of payments position. Import policy was primarily aimed at ensuring the availability of goods and services for domestic consumption as well an adequate volume of investment goods for economic development. In 1986, there were no significant changes in export and import control policies, other than few marginal modifications in the licensing system and the export and import tariffs. In regard to imports, while major items remained free of controls, the import of fertilizer was brought under licence, in addition to the 20 items which required export licences at the beginning of 1986. The latter mainly consisted of products such as wood timber and minerals.

The merchandise, services and current account of the balance of payments showed a slight improvement in 1986. But overall there was a deficit of SDR 74 million on top of a deficit of SDR 111 million in 1985. Total export proceeds decreased from Rs. 35.7 billion in 1985 to Rs. 33.8 billion in 1986. Earnings from exports of both agricultural and industrial products fell during the year, but the sharpest decline was in agricultural exports where the fall was 30 per cent. Import payments in 1986 fell by 16 per cent and was due to the downward movement in import prices notably rice, sugar, wheat and other consumer goods.

The sharp decline in tourist arrivals due to unsettled conditions prevailing in the country, reduced earnings from travel and allied services considerably. However, foreign exchange payments on account of Sri Lankans travelling abroad continued to rise following a trend which started in 1983 with further relaxation of exchange controls. The total net outflow of private remittances consisting of profits, dividends and interest increased from SDR 125 in 1985, to SDR 188 million in 1986. Although lower than in earlier years, interest payments in 1985, and 1986, were the largest single item in the services account. This was mainly the outcome of the increased use of commercial borrowings in the preceding years for balance of payments purposes and large commercial borrowings made by some private sector institutions.

The government budget deficit increased sharply in 1986 owing to a large number of supplementary expenditure votes which were accommodated during the year. Depressed commodity prices contributed to reduce revenue collections from the tea ad-valorem tax and corporate income tax. However, tax revenue of the government was maintained at a high level by introducing further levies on imports and exports. Furthermore, the increase in recurrent expenditure declined from 17 per cent in 1985 to 3 per cent in 1986 owing to the slowing down in expenditure on subsidies and other goods and services. Despite these developments, there was a larger budget deficit in 1986. The total budget deficit as a proportion of GDP remained at about the previous year's level of 16 per cent. The budget deficit in 1986 was a matter of concern because imbalances in Government finances had been a major factor contributing to increase the money supply and prices and the cause of disequilibrium in the balance of payments. Recognising these factors and the adverse consequences of higher deficits on the economy, the government reaffirmed its commitment to reduce the budget deficit through a series of measures which were presented with the budget for 1987. This policy emphasised the need for consistency in the strategy for correcting long standing weaknesses in the economy.

Since the commencement of the new economic policies in 1977, the performance of the economy in 1987 slowed down considerably. The gross domestic product increased only by 1.5 per cent which was the lowest since the economic reforms of 1977. The average rate of growth of the real GDP in the 10 year period 1977 - 86 was 5.5 per cent. The modest economic performance in 1987 in turn had an impact on the budget and the balance of payments. There was a pronounced set-back in agricultural production, mainly due to unfavourable weather and continuous civil disturbances in the North and the East. However, in 1987, there was a slight improvement in the performance of exports which was largely due to higher earnings from industrial exports and gems. Industrial exports rose by 20 per cent an increase from Rs. 15.8 billion in 1986 to Rs. 20 billion in 1987. With this increase the share of industrial exports in total exports rose to 49 per cent.

Sri Lanka's balance of payments both in the trade and current account improved in 1987. The deficit in the merchandise trade account declined from SDR 469 million in 1986 to the SDR 531 million in 1987. As a result, the current account faired better with the deficit decreasing from SDR 363 million to SDR 266 million. The ratio of the current account deficit to the GDP, which is a good indicator of the degree of weakness of the balance of payments, came down from 6.6 per cent in 1986 to 5.2 per cent in 1987. Even with these developments, the balance of payments as a whole continued to be in deficit and the short fall in 1987 was SDR 72 million. The cumulative drop in net export receipts contributed to substantial deficits in the overall balances in the last three years siphoning off almost 90 per cent of the foreign exchange earnings from the tea boom of 1984-85.

The budget deficit in relation of GDP declined from 12.2 per cent in 1986 to 10.6 per cent in 1987 which clearly showed an improvement in the fiscal outlook. Several factors contributed to this. First, despite the slow growth in government revenue from income taxes, general sales and turn-over taxes; the overall growth in government revenue was maintained at a high level, by means of international trade oriented taxes and non tax revenue sources. Secondly, advance account transactions which had been a major element of budgetary imbalance in this period, showed a substantial improvement and helped to generate a surplus. Thirdly, the supplementary expenditure required for defence was found from other ministries, by imposing a 11 per cent cut on their capital expenditure allocations.

Extension of Liberalisation on a Wider Front After 1988

The year 1988 represents a clear watershed in the further progress of economic and financial reforms. The second and a more significant phase of liberalisation started in 1989 when the private sector was given the lead role and priority was given to export led economic growth. The election of a new President in December 1988 followed by the new Parliament in February 1989 enabled the new President to push forward the on going progressive liberalisation programme in all directions. This was facilitated to a great extent by the restoration of law and order in the country from the latter part of 1989. It is relevant to mention that in the preceding period 1987 to 1989, the achievements of the government took place under very chaotic conditions. From 1987, Sri Lanka once again witnessed an escalation of violence leading to a major crisis in 1989 when threats to the lives of the armed forces, the civilians, employees in public and private business concerns, the general public and school children resulted in work stoppages and closure of educational institutions and a near total break down of the administration.

As a consequence of the difficulties experienced in 1987/88, which was unprecedented, the increase in the GNP that year was only 2.7 per cent. This was achieved in the context of wide spread civil disturbances which unfavourably affected production and distribution. However, during 1988, agricultural production improved somewhat, while the manufacturing sector showed steady growth. The year produced good paddy crops both in the Yala and Maha seasons.

Although in the period 1985-87 a single digit level of inflation prevailed, 1988 saw a reversal of this trend when Colombo Consumers Price Index rose by 14 per cent as compared with the increase of 7.7 per cent in 1987. Several factors contributed to the sharp price increase, but most notable was the escalation of civil disturbances and the upward revision of the business turnover tax. The increase in the money supply and substantial wage increases given to several key sectors of the economy tended to activate consumer demand.

The developments in Sri Lanka's external trade in 1988 were unfavourable and showed an increase in exports of only 2 per cent in SDR terms as compared with 4 per cent in 1987. While expenditure on imports had fallen by 4 per cent in 1987, there was an increase of 5 per cent in 1988, and as a result, the trade deficit increased by 12 per cent in 1988 in sharp contrast to a reduction of the deficit by 18 per cent in the previous year. The slow growth of export earnings was not due to any major changes in the liberal policies, which had by then been in existence for 10 years. The export earnings were adversely affected by the disruption of production arising from the civil disturbances. The higher expenditure on imports was mainly the result of an increase in both the price and volume of major import items.

In the context of the slow growth in export earnings there were hardly any changes in the structure of exports in 1988. As in the earlier years, industrial exports constituted the predominant category, accounting for about 48 per cent of total exports, while the textiles and garments category remained the largest single export item. In the meantime, the share of traditional export crops, tea, rubber and coconut which accounted for 38 per cent of total exports in 1987 declined to 37 per cent in 1988. In all, Sri Lanka's balance of payments showed a considerable deterioration in 1988. The deficit in the merchandise account rose by 9 per cent from SDR 525 million to SDR 574 million. The current account also followed the same trend showing an increase in the deficit by 22 per cent rising from SDR 265 million in 1987 to SDR 324 million in 1988. The current account deficit as a ratio of GDP rose from 5.1 per cent in 1987 to 6.2 per cent in 1988 bringing to light the diverse pressures that came upon the balance of payments in that year.

A major development of liberal economic policies was the increasing numbers of people who sought employment in the Middle East and government provided additional facilities for this purpose. The lifting of all travel restrictions after 1977 made it possible for people to find employment abroad, and since the early 1980's, this had been a major support to the balance of payments, adding considerable strength to the balance of payments from remittances. However, remittances which reached a peak in 1984 tended to decline. Receipts from these private remittances were SDR 262 million in 1987 compared to SDR 270 million in 1980. However, in rupee terms these remittances showed an increase of 8 per cent from Rs. 10.3 billion in 1987 to Rs. 11.1 billion in 1988. In 1988, capital inflows both official and private were sufficient to finance only 60 per cent of the much larger current account dificit and the total deficit had to be financed by using foreign exchange reserves. External assets declined by SDR 22 million or 5 per cent in 1988 and this was the fourth consecutive year when external assets had to be used extensively to finance the balance of payments deficit.

The adverse balance of payments developments in 1988, arose from several factors. The continued civil disturbances prevented a further increase in exports. The prices of basic food stuffs imported by Sri Lanka, particularly, rice, wheat grain, sugar and some intermediate goods such as fertilizer, rose in the world market. A further important factor was that the implementation of financial and macro economic adjustment policies, which were designed to improve the balance of payments position, were interrupted by the heavy demand made for resources by the unsettled conditions that prevailed. Furthermore, this uncertainity also prevented certain anticipated private and official capital flows from coming in.

It 1988,as in the case of the balance of payments there was a sharp deterioration in government finances. The current account of the budget showed a deficit of Rs. 6.0 billion or 2.7 per cent of GDP in 1988 in sharp contrast to a surplus of Rs. 2.5 billion or 1.3 per cent of GDP in 1987. The total budget deficit in 1988 was Rs. 13.8 billion or 25.2 per cent of GDP as compared with the deficit of Rs. 21.7 billion or 11.1 per cent GDP in 1987. The sharp deterioration in the government finances in 1988 was due to the widespread disturbances leading to lower revenue collections, secondly, to the increased commitments for the payment of wages and personal emoluments, interest payments, drought relief, food stamps and a substantial increase in current expenditure to meet the security needs. Furthermore, a large number of supplementary capital estimates were introduced during the year mainly to meet cost escalations in all on-going projects.

One factor that worsened the financial situation was the increased borrowings for budgetary purposes from the banking system which rose to an all time high in 1988 of Rs. 9 billion which was 4 per cent of GDP. The need for this action arose because of a sharp shortfall of revenue accompanied by a considerable increase in expenditure, mainly attributable to defence and wage increases in the public sector. Credit to government from the Central Bank rose by Rs. 8.3 billion or 34 per cent during the year while borrowings from the commercial banks were Rs. 710 million. These borrowings tended largely to increase bank reserves.

In the background of less favourable trends evident in the economy, the country adopted the "Medium Term Economic Policy Framework" for structural reforms to be implemented in the period 1988-91, which would provide the ground for rapid and sustained economic growth. This policy framework aimed at a progressive reduction of the budget deficit and the balance of payments deficit and to cut down inflation. However, most of the objectives laid down in the first year of this programme could not be achieved because of unsettled conditions. On the one hand, because 1988 was the election year, government expenditure tended to grow rapidly adding pressure on resources while, on the other, the country continued to face a major obstruction to economic growth due to insufficient domestic savings and investment. The domestic savings rate has tended to stagnate for the four years preceding 1988 at 12.5 per cent of GDP, mainly because of the unsatisfactory performance of the export trade, while the annual average rate of investment remained at 23.4 per cent.

In 1989 too. the performance of the Sri Lanka economy was not much better than in 1988. The relatively low growth rate of 2.3 per cent was achieved in the background of unabated civil disturbances and ochestrated work stoppages which affected economic activity and even to a great extent underminded business confidence. The performance of the agricultural sector was less significant than in 1988, while the major contributors to economic growth in 1989 were manufacturing and the services sectors. The external trade situation improved some what in 1989. Exports increased by 11 per cent to Rs. 56.1 billion, as compared to a growth of less than 2 per cent in 1988. Import expenditure rose by 5 per cent to Rs. 80.2 billion which was the same rate of increase as in 1988. As a result, the trade deficit in 1989 dropped by 8 per cent to Rs. 24 billion. Export earnings as a ratio of imports payments increased significantly from 66 per cent in 1988 to 70 per cent in 1989. The higher earnings from exports in 1989, was mainly on account of tea, coconut, textiles, garments and other industrial exports. The composition of the country's exports underwent further change in 1989, with the share of industrial exports rising from 48 per cent in 1988 to

51 per cent in 1989, while the share of agricultural exports declined from 43 per cent to 39 per cent. This shows that there have been further gains in the broader strategy of diversifying exports and increasing the share of industrial exports; a major objective of the on-going liberal policies. The merchandise account of the balance of payments produced a deficit of Rs. 24.7 billion in 1989 which was 5 per cent lower than the deficit of Rs. 24.2 billion recorded in 1988. The current account deficit at Rs. 12.9 billion remained more or less at the same level as in 1988.

The outstanding feature in 1989 was the marked improvement in the financial position of the government, which turned out to be even better than in the original estimates as well as in regard to the targets set out in the economic stabilisation programme. The overall budget deficit was kept down to Rs. 25 billion or 10 per cent of GDP, as compared to the targeted deficit of 12.5 per cent of GDP and the actual deficit in 1988 of 15.6 per cent. This improvement was the outcome of the ability to obtain much more revenue and sharply reduce expenditure. Government revenue as a GDP ratio was more or less at the targeted level of 21.3 per cent, while the large reduction in government expenditure enabled total expenditure as a proportion of GDP to be reduced to 31.6 per cent as against the 33.8 per cent of the original target. Government revenue in 1989 at Rs. 54 billion showed an increase of 29 per cent, tax revenue was Rs. 37.4 billion, an increase of 32 per cent and contributed about 90 per cent to total revenue in 1989 as compared to 86 per cent in the previous year. Revenue collections from major sources of import duties and turnover tax were considerably higher than those from the same sources in 1988. The expenditure on salaries and wages at Rs. 12.9 billion was an increase of over 30 per cent against the previous year and as a proportion of GDP rose to 5.2 per cent in 1989 from 4.5 per cent in 1988.

Meanwhile transfer payments in 1989 were Rs. 16 billion which is an increase of 25 per cent over the previous year. Interest payments on the government debt was Rs. 14.4 billion showing an increase of 13 per cent. In contrast to these increases in current expenditure, total capital expenditure of Rs. 19.5 billion showed a drop of 14 per cent in 1989 and as a result the ratio of capital expenditure to GDP came down from 10.3 per cent in 1988 to 7.9 per cent in 1989. The declining capital expenditure was due to the difficulties experienced in implementing foreign funded projects such as the rehabilitation programmes and road development projects, because of unsettled conditions that prevailed. The total government debt at the end of 1989 was Rs. 272 billion which is an increase of 21 per cent over the level in the previous year. The domestic debt was Rs. 117 billion and showed an increase of 19 per cent, while the foreign debt at Rs. 154 billion was 23 per cent higher. Meanwhile, the share of short term debt in total debt rose from 47 per cent in 1988 to 54 per cent in 1989.

The adjustment programme which was introduced in 1988 was further activated in 1989 and was aimed at stabilising the economy by reversing the adverse external trade position by achieving a reasonable level of balance in the government finances and checking increases in prices resulting from the expansion of money. The aim of the programme was to first reduce the fiscal deficit by cutting down expenditure and increasing revenue. The overall budget deficit was to be reduced to 12.5 per cent of GDP in 1989 and to a further 10 per cent in 1990. Secondly, the current account deficit in the budget was to be reduced to 10 per cent of GDP in 1989 and to be further reduced to 9 per cent in 1990. Inflation was to be brought down to 12 per cent in 1989 and to 10 per cent in 1990. Domestic cost and price distortions were to be corrected by adjusting administered prices. Credit growth was to be restrained and reforms introduced in the financial sector. Exchange rates were to be managed with flexibility and the administration of public enterprises were to be improved. Finally the overstaffing in the public services were to be reduced. All these measures were designed to rapidly achieve all round economic stability and the economy was to be put on a path to long term economic growth.

The performance of the economy in 1989 showed that in broad terms the stabilisation programme had achieved its objective of introducing major improvements in financial and economic management. The attempts to stabilise the economy received some support through a marked improvement in the security situation in the last few months of 1989. But, by that time the budget deficit had declined even further to 10.4 per cent of GDP as against the laid down target of 12.5 per cent. Marked improvements in the budgetary situation came about through improved revenue collection, strict controls on government expenditure and by reducing expenditure on certain capital projects. Sharp reductions in the rate of growth of money was achieved by severely cutting bank credit to the government and the private sector. The government also reduced its borrowing requirements through better cash management, rationalising expenditure and an aggressive open market policy of the Central Bank enabled the Bank to sell a large portion of its holdings of Treasury bills in the market. All these resulted in the total elimination of bank financed funds for budgetary purposes by 1989. Quantitative restrictions were applied on private sector credit for non-essential purposes and this along with the aggressive open market operations of the Central Bank helped to moderate the growth of credit to the private sector.

The favourable outcome of government finances also helped to improve the balance of payments situation. Although the current account deficit targeted for 1989 was 10 per cent of GDP, the country was able to reduce the deficit to 9 per cent of GDP in 1989. The gross external assets of the banking system increased from Rs. 18.4 billion at the end of 1988 to Rs. 21.7 billion at the end of 1989, raising the country's import capacity to 3 months. The overall deficit in the balance of payments was reduced to SDR 67 million in 1989 from the targeted deficit of SDR 170 million. Likewise, the increase in the cost of living index which was 14 per cent in 1988 was brought down to below 12 per cent in 1989. Undoubtedly the level of economic stabilisation achieved in 1989 was indeed very commendable, considering the fact that such stabilisation was achieved in the midst of continuing civil disturbances which prevented an appreciable reduction in defence expenditure.

While the government actively pursued the new financial reforms to stabilise the economy, from a social stand point, in order to protect the vast majority of the population from certain possible unfavourable effects of economic liberalisation and to alleviate poverty on a very wide scale, the government launched the Janasaviya Programme in 1989. The programme was designed to reach the poor in several stages. The first round was implemented in October, 1989 in 28 Assistant Government Agents Divisions all over the Island. The number of families that benefited from the first round was 156,245 and in the second round, commencing in December 1990, a total of 77,260 households were covered. The expenditure involved in the implementation of the first round in 1989 was Rs. 705 million, Rs. 3.6 billion in 1990 and Rs. 7.5 billion in 1991. The expenditure on the Janasaviya programme more than doubled in 1990 and remained at a high level in 1991. In 1989, the welfare expenditure of government consisted of the Janasaviya with an expenditure of Rs. 705 million, mid day meal Rs. 605 million and food stamps Rs. 3,180 million. All these meant the allocation of more funds from the budget on social welfare, but all these monies, unlike before, were properly targeted.

More Financial Reforms and Exchange Control Relaxations

Most of the difficulties which Sri Lanka faced in regard to security matters within the Island were over by 1990, except for the on-going conflict with the Tamil terrorists in the North and the East. Normality had been restored in the rest of the Island and conditions therefore were right for further reforms on a wide range of fronts and for speeding up economic growth. Within the framework of more economic reforms, considerable attention was paid to poverty alleviation and the upliftment of the poor from 1989 onwards which commenced with the Janasaviya. It represents the efforts made to broad base the impact of development by dealing with poverty problems in a more direct manner, while further providing the economy with facilities and concessions which would promote rapid growth and also provide a base for private sector led investment. The year 1990 has seen the beginning of a series of measures to further free the economy, attract foreign investment and to liberalise, to a greater extent, the trade and exchange controls that remained.

Since 1988, Sri Lanka adopted a policy of encouraging an even greater inflow of foreign capital as a means of making available financial resources, technology and skills necessary for private sector development. Many of the financial liberalisation measures to encourage capital inflows, centred round the Colombo Stock Exchange, the Greater Colombo Economic Commission, now designated as the Board of Investment, and the Department of Exchange Control. All these new measures, which were rapidly introduced, had far reaching and significant impacts on both the balance of payments and the government finances. In June 1990, the 100 per cent transfer of property tax on share transfers between foreign share holders was totally abolished. This indeed had a favourable immediate effect on the balance of payments and on the price of shares traded in the Colombo Stock Exchange. The inflows of capital that took place helped to boost the country's foreign exchange reserves which were in August/December 1989 at the lowest level in the country's history.

Although, the abolition of the transfer tax meant that government revenue came down to some extent, the revenue from other sources increased rapidly due to the buoyancy of the economy and the emergence of a wider variety of new activities in the agricultural, industrial and services sectors. In October 1990, individuals resident outside Sri Lanka were permitted to invest up to 40 per cent in the issued equity of listed companies. All inflows of capital and the repatriation of dividends in regard to these investments were to be channelled through Share Investment External Rupee Accounts in commercial banks with automatic exchange control clearance for these transactions. In November 1990, the Capital Gains Tax on the proceeds of sales of shares held for more than one year was abolished. If the sales of such shares took place within the first year, a tax of 20 per cent was payable. Simultaneously the stamp duties payable for share transfers were abolished as a further means of giving a boost to the stock market. These measures were essential to promote both foreign investment and to give incentives to local investors. It tended to attract more money into the share market and activated a considerable amount of rupee funds that had remained dormant for quite some time. These measures encouraged foreign equity investment and therefore tended to strengthen the balance of payments through the inflow of funds from overseas.

In November 1990, government issued an investment policy statement which invited direct foreign investment in Sri Lanka and permitted the Greater Colombo Economic Commission to authorise automatic investment approvals in most projects where there was up to 100 per cent foreign equity participation in such ventures. However, a small number of activities such as prospecting and mining for non renewable sources and production for domestic markets were to be evaluated by the GCEC on a case by case basis where foreign equity participation exceeded 40 per cent of the total issued capital.

As a result of the liberalisation measures taken with respect to the stock exchange, which is extremely sensitive to investors confidence, activity in the stock market surged to new heights. The renewed confidence of investors in the economy was seen in the significant increase in turnover in the stock market and in the very sharp rise in share prices after 1990. In 1990-91, 43 country and regional funds had obtained approval to participate in the stock market and purchases of shares by foreigners amounted to Rs. 253 million in the second half of 1990 and to over Rs. 1 billion in the first 9 months of 1991. The reinvigoration of stock market activity was evidence of the success of the further reforms and the liberalisation of financial policies in 1991. The widest range of financial reforms that this country has seen took place in 1990-1991, and in the context of the other South Asian countries, Sri Lanka provided the lead in liberalisation, which was of course, closely followed by Pakistan and India. All these reforms and liberalisation measures stood in good stead with a significant upsurge in economic activity in 1990 with a noteworthy turn around in the balance of payments and a spectacular improvement in the management of government finances.

As a result, Sri Lanka's growth rate in 1990 was the highest for more than a decade reaching 6.6 per cent. In the balance of payments there was an overall surplus of SDR 130 million, the first year to record a surplus after 5 years. The budget deficit as a ratio of GDP declined from 15.7 in 1988 to 11.2 per cent in 1989 and dropping further to 9.9 per cent in 1990. The only area of concern for the administration was the monetary expansion and ensuing rise of prices. With the boost in economic activity the year also saw a significant increase in domestic savings going up from Rs. 30.8 billion in 1989 to Rs. 47.4 billion in 1990, and as a ratio of GDP, domestic savings rose from 12.2 per cent to 14.8 per cent. Meanwhile national savings which includes factor income and remittances from abroad as a ratio of GNP rose from 14.6 per cent to 17.5 per cent in these two years. The rise in savings undoubtedly was an encouraging development considering the fact that these occurred when there were considerable inflationary pressures present in the economy. Capital formation rose significantly in 1990 laying the foundation for the future growth of the economy. Gross domestic capital formation showed an increase of 33 per cent in 1990 as compared with the increase of only 8 per cent in 1989.

In 1990, tea production reached 233 million kilograms which was the highest level ever achieved and a 13 per cent increase over the previous year. Industrial production and value added in industry reached very high levels in 1990. Industry revived after the end of civil disturbances in most parts of the country and rose by 14 per cent, the highest rate of growth recorded since 1984. All categories of major exports significantly increased in 1990, where earnings rose by 11 per cent against the growth of 1 per cent in the previous year. In particular, industrial exports recorded an impressive growth of 24 per cent in 1990. The predominance of industrial exports which was evident in the 1980's was even more marked in 1990 with the share of this category rising from 51 per cent to 52 per cent. On the other hand, the production of agricultural crops which altogether accounted for 75 per cent of export earnings in 1977 dropped sharply to 32 per cent in 1990. Among industrial products textiles and garments continued to be the largest export item maintaining its lead position. However in the context of the new expanded development efforts, total imports were Rs. 107.7 billion in 1990 compared to Rs. 80.2 billion in 1989 which is an increase of 14 per cent. The expenditure on investment goods rose by 35 per cent from Rs. 12 billion to Rs. 19 billion and was due largely to the rise in the importation of equipment and machinery for new industries and vehicles for the transport trade.

The significant improvement in the country's balance of payments was due to several favourable factors which emerged as a result of the further series of liberalisation measures in trade, payments and exchange control. This was assisted by the continuing buoyancy in tea prices which strengthened the balance of payments and government finances to a large extent. The deficit in the services account of the balance of payments showed a significant reduction from Rs. 5.6 billion in 1989 to Rs. 3 billion in 1990. This came about through more foreign exchange earnings from travel, port transportation, insurance and investment incomes. Even with the liberalised exchange measures and more Sri Lankans travelling abroad and the utilisation of foreign exchange allocations for travel to the hilt, there was less pressure on the services account. The recovery of tourism with more tourists arriving, resulted in a 75 per cent increase in earnings ; receipts from tourism rose from SDR 9 million in 1987 to SDR 44 million in 1990. Worker remittances which accounted for a major share of private transfers also increased in a big way rising from Rs. 12.8 billion in 1989 to Rs. 16 billion in 1990. Thus dispelling the fear that there would be a reduction in the remittances following the occupation of Kuwait by Iraq. The capital account of the balance of payments was more favourable in 1990 than in 1989, where non monetary capital inflows increased by 38 per cent to reach SDR 297 million and this was mainly due to the increased utilisation of foreign loans. Private direct investment rose slightly from SDR 14 million in 1989 to SDR 15 million in 1990. The overall balance of payments position helped to bolster the country's foreign exchange reserves which rose by Rs. 5.6 billion in 1990 as compared with an increase of Rs. 2.4 billion in 1989. The country's total foreign exchange reserves stood at Rs. 34.2 billion at the end of 1990 and these reserves were sufficient to finance 3.6 months of imports projected for 1991.

One of the most welcome developments in the balance of payments in 1990 was the sharp reduction in debt service. These payments as a ratio of receipts from exports of goods and services declined from 24.6 per cent in 1989 to 16.5 per cent in 1990 which reflects the reduction in debt service payments and an increase in export earnings. The new budgetary measures introduced in 1989, undoubtedly helped to make further improvements in government finance arrangements and to maintain a satisfactory and sustainable budget deficit. The deficit as a whole was kept within the 10 per cent target of the on-going stabilisation programme and the new fiscal measures helped to increase revenue and reduce expenditure and this greatly assisted in realising the deficit targeted for 1990. The revenue DGP ratio of 21.2 per cent in 1990 was a result of efforts made to maintain high revenue targets. The Treasury was able to reduce the current expenditure to GDP ratio to 22.4 per cent in 1990 from the previous year's level of 22.6 per cent. Capital expenditure as a ratio of GDP dropped further from 10 per cent in 1989 to 8.8 per cent in 1990. Tax revenue from domestic goods and services increased by 38 per cent reaching Rs. 28.7 billion and accounted for about half of the total tax revenue. International trade taxes produced Rs. 19.3 billion and provided 32 per cent of the tax revenue in 1990. Receipts from income taxes and taxes on property transactions rose by 34 per cent in 1990 reaching Rs. 10.4 billion where as the increase in 1989 was 22 per cent.

In 1990, the third year of the Structural Adjustment Programme introduced in 1988, was in progress. It was designed to develop and strengthen the economy and to lay a firm basis to sustain economic growth with price and balance of payments stability. Structural reforms in 1990 covered a wide range of areas. It rationalised public expenditure, eliminated a number of subsidies, notably those on wheat flour, rice and fertilizer, resulting in budgetary savings of about 1 per cent of GDP. Many public enterprises were peoplised. Considerable progress was achieved in reducing commitments of the budget to public transport by the upward revision of fares. The welfare expenditure of the on-going Janasaviya and mid day meal programmes were continued within manageable levels through better targeting. As a further step towards trade liberalisation, the tariff system was simplified and the maximum tariff rates were brought down to 50 per cent.

In 1991, the liberalisation programme was further extended and additional measures were put into effect to attract foreign investment and to further promote business and economic activity. In January 1991, a sub-committee of the cabinet of ministers was appointed to meet weekly to co-ordinate and expedite direct foreign investment approvals by the Greater Colombo Economic Commission ; and the Industrialisation Commission, consisting of senior officials and prominent businessmen, was established to advise the government on measures to promote investment and industrialisation. In February, 1991, the resident guest scheme for expatriates was brought into operation where foreign investors could obtain a five year residence permit if they bring in a minimum sum of US$ 150,000/-. Professionals were permitted to become resident guests on payment of US$ 1,500/- monthly for their up keep. They could obtain citizenship at the end of a five year stay in the country with the approval of the government.

In March 1991, commercial banks were authorised to approve remittances by Sri Lanka based firms in respect of payments for consultancy, licencing, royalty and management on behalf of the Controller of Exchange. The approval of repatriation of profits and dividends by Sri Lanka based firms in the same manner had already been authorised by the Controller of Exchange in 1985. In July 1991, foreign investors were exempted from the provisions of the Exchange Control Act. In June 1991, commercial banks were permitted to open numbered accounts on behalf of non resident Sri Lankans or foreign nationals. About the same time, money changers were allowed to operate in Sri Lanka which authorised them to purchase foreign exchange currency notes and convert them to other currencies. In March 1991, resident Sri Lankans were permitted to import unlimited amounts of non convertible currencies as long as they declared these amounts to the Customs on arrival. Further exchange relaxations were made in the first half of 1991 and these included the release of funds in blocked accounts owned by non resident foreign citizens, which were awaiting repatriation. Passengers arriving and leaving the Island were exempted from the requirement of declaring foreign currency if the amount was less than US$ 5,000/-. Commercial banks and authorised travel agents were permitted to approve the purchase of air tickets with foreign exchange without reference to the Controller of Exchange. In June 1991 the exchange control regulations which stipulated that Sri Lankan nationals had to declare their foreign assets were withdrawn and in August 1991, all residents in Sri Lanka were permitted to open Resident Foreign Currency Accounts either with remittances from abroad or monies brought into the country, provided a minimum deposit of US$ 500/- or its equivalent in other currencies was deposited in the bank account.

The impact of most of these relaxations were immediately felt and had a favourable effect on the balance of payments. Event hough the exchange control relaxations allowed Sri Lankans to use more money for travel overseas, on the other hand, the inducement offered for people to keep money in the country, mainly through the Resident Foreign Currency Account Scheme stimulated a substantial flow of funds in the form of foreign exchange into the banking system. It is estimated that one year after the operation of the Resident Foreign Currency Account Scheme, the amount of funds mobilised by the commercial banks had exceeded US$ 15 million. The main objective of these relaxations were achieved by giving greater confidence to both foreign investors and local residents in regard to the country's balance of payments and foreign exchange situation.

Unlike in the preceding years, particularly, before 1988, the possession of foreign exchange was no longer looked upon as an offence and a high level of convertibility was achieved in this respect. For all purposes, the Sri Lanka rupee was convertible, the only exception being that Sri Lankans could not freely purchase foreign exchange with rupees. People for the first time could hold or possess foreign exchange in bank accounts and use these funds in an unrestricted manner with no reference to exchange control. The entitlement of foreign exchange for travel, health and education was considerably increased in several stages thereafter. After June 1991, facilities for holiday travel abroad in terms of number of journeys were available on an unrestricted basis and the allowances for all categories of travel for holiday, educational and business were increased. International credit cards were also issued to certain categories of persons.

Although these measures did not have an immediate impact on the budget, over a long period favourable results could be anticipated through a general expansion in business and economic activity. Greater confidence, a higher level of investment and sbusines activity would result in the increased production of goods and services, and as a result, more revenue would be available to the government in the mfor of turnover tax, income tax and other revenue levies. One of the more favourable results of these continuing reforms was the progressive increase in the country's foreign exchange reserves. Unlike in the earlier years there was evidence that exporters were now bringing funds into the country, because in the period after 1989, although there was no commodity boom and prices of the main exports were not rising significantly, there was evidence that more and more funds that exporters earned came back to the country. Furthermore, there was also evidence that holders of funds, particularly Sri Lankan residents were now anxious to retain them in local banks. The higher interest rates prevailing in Sri Lanka, as against the European and other countries, were further inducements for Sri Lankans and expatriates to hold their monies in convertible accounts in Sri Lanka than abroad.

The main impact of these policies were particularly evident in 1991 and 1992. In 1991, the Gross Domestic Product increased by 4.8 per cent, although it was less than the 6.2 per cent increase in the previous year. The increases in external reserves were evident despite the sluggish growth in exports and a large increase in imports in 1991 which contributed to widen the trade deficit. This was indeed a reversal of the trend which appeared in the three previous years when the trade account deficit tended to decrease. Exports increased only by 2 per cent to Rs. 84 billion in 1991 as compared with the massive growth of 20 per cent to Rs. 126 million in 1990 and as a result, the deficit in the trade account rose to Rs. 42 billion in 1991 from Rs. 28 billion in 1990. One reason for this adverse trend was that the prices for Sri Lanka's exports and imports were unfavourable throughout the year, resulting in a deterioration in the terms of trade by 1.9 per cent. The price of tea fell sharply, while the prices for major imports such as fertilizer, textiles and transport equipment rose significantly.

Most exports fared badly in 1991. Plantation exports fell by 12 per cent, while earnings from petroleum, gems, diamonds and other mineral products declined by 21 per cent, 22 per cent, 23 per cent and 60 per cent respectively. The value of industrial exports increased by 17 per cent and the larger share of this was in textiles and garments. With these developments, the composition of exports underwent a major change. The share of industrial exports rose from 52 per cent in 1990 to 60 per cent in 1991, the share of other exports fell to 31 per cent in 1991 from 36 per cent in 1990. While there were deficits in both the trade and services accounts in the balance of payments in 1991, a large volume of resources in the form of transfers to the capital account were more than sufficient to off set the deficit in the trade and services account. As a result, on the whole, the balance of payments produced a surplus of SDR 150 million following a surplus of 133 million in 1990.

It needs to be emphasised that these transfers of capital were mainly due to the very favourable effects of the further financial and other reforms that were made in 1989 and 1990 which have been referred to already. Net private transfers rose by 7 per cent to SDR 288 million, while worker remittances accounted for a major share of private transfers. In regard to the capital account transfers, there was an increase of 38 per cent from SDR 344 million in 1990, to SDR 475 million in 1991. One significant feature was the very marked increase in private investment from SDR 31 million in 1990 to SDR 79 million in 1991. These increases occurred in both direct foreign investment and portfolio investment through the Colombo Stock Exchange.

Since the new financial measures take time to have an effect on the government finances, fiscal operations in 1991 constituted a set back to the adjustment effort made in the preceding years. The fall in revenue and the increase in current expenditure contributed to this situation. The overall revenue GDP ratio fell from 21.2 per cent in 1990 to 20.3 per cent in 1991, while current expenditure to GDP ratio remained almost unchanged. However, capital expenditure increased from 8.8 per cent in 1990 to 9.5 per cent in 1991 and as a result, the overall budget deficit as a percentage of GDP ratio rose from 9.9 per cent to 11.5 per cent.

The foregoing assessment of the impact of financial and other reforms on the budget and the balance of payments highlights several noteworthy aspects. The analysis has already made a distinction between the first 10 years of the exercise and the succeeding five years. One thing is clear, that is in the first 10 years, the liberalisation programme did not go far enough to the point where it could produce a significant stimulus to increase exports and to attract foreign investment and to enable the country to have access to a greater volume of savings for its development effort. Export growth was somewhat sluggish in the first ten years up to 1987 and the only relief that the country was able to get was the sharp improvement in commodity prices which occurred at times during this period, which helped to bring about a significant improvement in the terms of trade and therefore, have a salutory effect on the balance of payments and on government revenue and expenditure.

The first ten years also coincided with an investment programme which was based on four lead projects which were pioneered by the most important project of them all, the Accelerated Mahaweli Programme which tended to preempt a considerable amount of local and foreign resources from other priority investments. As a result, there was much less emphasis on the export effort in general, even though the broad objective was export led growth. Other exports except garments and textiles received little impetus. The development effort did not seem to have a proper balance with the greater emphasis on a few large projects. To some extent, this led to the neglect of smaller projects which would have a significant impact on living standards and the balance of payments. There was at the same time, especially after 1983, widespread disturbances which destabilised the economy and the administration and had adverse results on government finances and the balance of payments. The government did not carry out its development programme on schedule and on the other side, there was the problem of shortfalls in revenue, escalation of expenditure on the major projects, rising costs and more expenditure on items like defence and rehabilitation. All these did not enable the government to obtain optimum results from the liberalisation and financial reforms. These factors presumably hindered the government from taking further liberalisation measures and introducing financial reforms. Conditions were such therefore that investor confidence was at a low level and did not encourage large private capital flows, as was the case after 1990.

The government, because it had a very ambitious development programme, under the four lead projects had to obtain extensive foreign credits to finance these projects and the occasional favourable shifts in the terms of trade and improvements in export prices were not sufficient to produce the volume of resources which would have been adequate to finance the normal commitments and the cost escalations in the large development projects, which in turn, was also due to the depreciation of the rupee. Since these projects did not have a direct impact on production and business activity, income growth was slow. Equally, the spread effect of these projects were limited and the government did not have an opportunity of undertaking a large number of highly productive small and income generating projects in the rest of the Island particularly in the rural areas, as was the case after 1989. The export effort, of course, during this period, was not very encouraging because exports increased only with the favourable movements of the terms of trade and the rise in commodity prices, and was not due to a significant growth in non traditional exports other than garments.

In contrast to the period before, after 1988, the liberalisation policies were expanded and extended with a much wider coverage and the government showed a positive appreciation of the need to do this because it was anxious to get rapid results. There was much greater diversification in the economy after 1988, and much more attention given to private and local investment. Furthermore the government through its poverty alleviation and other rural sector programmes was able to increase production very sharply at the village level. The tremendous increase in productive activity in all sectors undoubtedly had a more favourable effect on the balance of payments as the export effort got into stride. The decade from 1990 was designated the decade of exports and for the first time there was singular attention paid to export led growth in a very big way. Most of the procedural difficulties which exporters had were removed and additional financial incentives such as obtaining foreign exchange lines of credit at low interest rates given.

Therefore, taking both periods into account, the very high export targets which were laid down in the plans did not materialise in either period. However, the export effort after 1989 was more impressive and productive than before and these achievements were realised without any major commodity boom taking place which normally tends to show a higher export growth due to the rise in export prices which sometimes occurs without an increase in the volume. This is therefore in contrast to the preceding period when commodity prices rose on several occasions. However, in the recent period, Sri Lanka had been able to increase its foreign exchange holdings even with deficits in the current account because there has been a large amount of foreign funds, both direct and portfolio investment, flowing in. This has, of course, greatly strengthened the balance of payments and helped to increase foreign exchange reserves. The most dynamic area in exports has been the garments sector where the growth in the period after 1989 has been far more impressive than in the preceding ten years when even at that time the lead sector was garments and textiles.

Conclusion

Although the process of liberalisation has extended over a period of 15 years, a distinction has been drawn between the first 10 years commencing in 1977 and the period after 1988. In the first 10 year period, the liberalisation process was only undertaken partially and considerable further relaxations had to be made to move towards a free and open economy. However, taking into consideration the difficulties which the country underwent during this ten year period, the liberalisation process undoubtedly continued but at a relatively slow pace, though export led development and the privatisation programme, were given a place, they were not pursued with vigour.

However, in this period, considerable progress was made in freeing the economy from a variety of controls and giving incentives to both local and foreign investment. These undoubtedly had favourable effects on the balance of payments, and the government budget. The freeing of imports and the accelerated development programme increased the requirements of capital and intermediate goods and put pressure on the balance of payments. For government investment programmes the budget had to provide additional funds. However, most of the large scale development programmes were financed to a considerable extent by foreign aid and loans and these helped to some extent to provide resources to undertake these programmes, while also meeting the cost escalations that took place due to inflation both overseas and at home. However, the measures taken by the government during this period laid a firm foundation for further financial and economic reforms in the period after 1988.

A far more balanced approach to liberalisation was taken in the last five years. While it paid considerable attention to export led growth, it placed equal emphasis, unlike in the earlier period, on the development of the rural sector through small scale enterprise and a poverty alleviation programme. In addition, the government actively pursued the policy of privatising state owned enterprises. To meet the commitments on the on-going development programme, the normal inflow of foreign exchange through exports and service income was inadequate and as in the previous period, foreign aid both grants and loans have figured in a big way in providing adequate resources. This not only reduced the strain on balance of payments but also helped to build up a substantial volume of external reserves. On account of these developments by March 1992, the foreign exchange holdings of the Central Bank had reached a very satisfactory figure of around US$ 900 million. This was not only a reflection of sound economic management, but also, the confidence that investors and people have had in the economy.

The export drive was also conducted on a much wider front and a large number of new activities and enterprises both small and medium scale have come into existence. It is not only the more developed and sophisticated manufacturing business concerns that have joined the export drive, but small enterprises in the rural areas and villages have also become more export conscious. Today the Board of Investment facilities have been extended to all economic enterprises irrespective of where they are located. Previously, mostly enterprises located in the free trade zones were given the Board of Investment concessions. The on-going development programmes and the further opening up of the economy and the relaxation of exchange and other controls have increased the demand for foreign exchange, and on the trade account under normal circumstances, unless there was a sharp increase in the prices of export commodities, a deficit normally emerged. However, due to a very satisfactory outturn in the services account with inflows of remittances and direct and equity investments, the balance of payments outcome on the whole has normally been satisfactory in the five year period. Furthermore loans under the IMF and World Bank assistance programmes have also helped to strengthen the balance of payments. There was also some evidence that there has been a substantial inflow of capital from abroad including funds held by expatriate Sri Lankans who have kept money outside the country.

In regard to the budget, the beneficial effects of the financial reforms have been firstly in the sharp reduction of government commitments to state operated enterprises. None of them have received subsidies and the privatisation or the sale of these concerns to foreign investors and the public has resulted in appreciable cash inflows to the government, which has helped the government to increase its revenue. It has also been totally relieved of financial commitments to these state enterprises. The second factor which influenced the budget, which has also been a part of the new financial policies, is the commitment of the government to ensure that the budget is properly managed and to minimise the deficits. Targets have been fixed in regard to the current account and overall deficits and these have been closely monitored and in most years these targets have been achieved. It is needless to mention that this difficult budgetary management was undertaken in the context of the need to finance the on-going war in the north and east.

The most recent liberalisation measures were announced at the end of March 1993 and they represent a further major step towards making the Sri Lanka rupee fully convertible. Presumably, these latest financial reforms were motivated by the announcements made in the Indian budget. However, it needs to be pointed out that in regard to liberalisation, Sri Lanka has been ahead of India or any other country in the region. India has made the rupee convertible only in respect of the trade account. Indian exporters have not been given the freedom to retain their proceeds abroad without repatriating them within a stipulated period, which is what Sri Lanka has now done. Instead, India had permitted exporters to convert 100 per cent of their export earnings at the current market rate, which represents a further depreciation of the Indian rupee. However, in Sri Lanka's case, the exporters are not required to convert any of the foreign exchange into rupees, but may hold it in that form either in Sri Lanka or abroad. In regard to the impact of these measures, particularly on the balance of payments and the reserves, it is a little too early to speculate.

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